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In the Supreme Court of the United States

OCTOBER TERM, 1978

IN THE MATTER OF GOLDEN ENTERPRISES, INC., BANKRUPT, WILLIAM E. BUTNER, PETITIONER

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE UNITED STATES

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OPINIONS BELOW

The opinions of the bankruptcy court (Pet. App. 2a-20a) and the district court (Pet. App. 21a-30a) are unreported. The opinion of the court of appeals (Pet. App. 31a-42a) is reported at 566 F. 2d 1207.

JURISDICTION

The judgment of the court of appeals was entered on December 8, 1977 (Pet. App. 31a), and a timely petition for rehearing filed on behalf of petitioner was denied on January 6, 1978 (Pet. App. 43a).

The petition for a writ of certiorari was filed on April 4, 1978, and was granted on June 12, 1978 (A. 803a-804a). The jurisdiction of this Court rests on 11 U.S.C. 47(c) and 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the mortgagee of real property is entitled to rents accruing during the period from the initiation of liquidation proceedings to the foreclosure sale of such property, where the mortgage does not provide for an assignment of the rents, the mortgagee does not seek to have the rents sequestered for his benefit, and the mortgagee has no equitable basis for his claim.

STATUTES INVOLVED

The pertinent provisions of Sections 57, 60, 67 and 70 of the Bankruptcy Act (11 U.S.C. 93, 96, 107 and 110) are set forth in the Appendix, *infra*, 1a-13a.

STATEMENT

1. *The Attempted Arrangement.* On May 4, 1973, Golden Enterprises, Inc. filed a petition for an arrangement under Chapter XI of the Bankruptcy Act, Sections 301-399 (11 U.S.C. 701-799). Golden had been engaged in commercial real estate operations and retail sales of merchandise. Its real estate operations were located in the vicinity of Hickory, North Carolina (Pet. App. 2a; A. 60a-63a). During the arrangement proceedings, Golden's retail operations were liquidated; however, it attempted to

improve its financial condition by continuing its real estate operations (see A. 69a-94a).

Golden's real estate consisted of four tracts of commercial property, referred to in the proceedings below as Tracts I-IV.[1] The arrangement plan, *inter alia*, envisioned the completion of income-producing improvements on Tract IV.[2] Tract IV was subject to a first deed of trust in the original amount of $755,000, held by Shelby Savings and Loan Association (A. 155a). On February 14, 1974, after considering various alternative financing arrangements, Golden moved to consolidate the various liens upon all of its properties, excluding the first trusts, into a $360,000 second deed of trust, in favor of petitioner William E. Butner, Robert L. McKaughn and Jack Sipe Construction Company.[3] Golden sought this consolidation in order to complete the proposed construction on Tract IV (A. 159a-160a).

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[1] In addition to Tracts I-IV, Golden owned other real estate which was also subject to a first trust and to petitioner's deed of trust. See A. 445a-458a. By consent, Golden abandoned these properties to the holders of the first trust (A. 418a-420a), and they are accordingly not involved in this litigation.

[2] Tract IV is sometimes referred to as the Tate Boulevard property (A. 294a).

[3] Petitioner and McKaughn had a pre-petition second trust on the property to secure a $250,000 note (A. 78a). The arrangement originally contemplated that a bank would advance $110,000, assume Golden's obligation secured by the second trust and consolidate the debts owed to it by Golden. In return, the bank would receive a second trust on all of the property in the amount of $460,000 (A. 80a).

The plan contained no provision for a security interest in the rents inuring to the benefit of the prospective holders of the second trust in the event of default. On April 17, 1974, the bankruptcy judge approved the plan (A. 195a-196a). His order provided that "the holders of the note or any assignee thereof shall not attempt to file a petition to reclaim or to foreclose except upon motion to this Court setting forth the reasons therefor" (A. 196a).

On April 18, 1974, the bankruptcy judge, pursuant to Golden's motion, appointed an agent "to collect rents and to apply the proceeds under the supervision of the Court" (A. 204a). The order further instructed the agent to apply the income received to the following debts of the corporation (A. 205a-206a):

1. Federal and State Income Tax, if any,
2. Monthly mortgage payments to First National Bank of Catawba County, Fidelity Federal Savings and Loan Association, and Shelby Savings and Loan Association (two loans),[4]
3. Ad valorem property taxes,
4. Fire insurance premiums, and
5. Interest and principal on secondary mortgages.

See also Pet. App. 2a, 11a-12a.

On July 1, 1974, the amended real estate plan was implemented. In accordance with the plan, the deed

[4] These institutions held the first trusts on the four tracts.

of trust contained no provision for a security interest in rents or profits arising from the property in the event of Golden's default (A. 445a-465a).

2. *Bankruptcy of Golden.* Golden operated as a debtor-in-possession, but the plan for an arrangement was never confirmed. On December 5, 1974, Golden moved to extend the time for completion of the arrangement, and for an order to show cause why it should not be adjudicated a bankrupt (A. 266a-278a). On December 30, 1974, however, petitioner and McKaughn filed an application seeking, alternatively, dismissal of the Chapter XI proceedings, and conversion into a Chapter X proceeding, or a removal of the court's "stay of execution on the above-described deed of trust" (A. 405a-406a). After a hearing, Golden was ordered to file an indemnity bond of $50,000 on or before February 5, 1975. Golden failed to file the required bond; following a subsequent hearing, Golden was adjudicated a bankrupt on February 14, 1975 (A. 337a-338a).

The arrangement proceedings had occurred during an economic recession when there were numerous foreclosures and general depression of real estate values (Pet. App. 5a). The bankruptcy judge found that if Golden's real estate had been liquidated during this period (Pet. App. 6a):

> the property would not have generated enough at auction to satisfy the first lien holders in full. Thus, the diligent efforts of * * * [the creditors' committee, its attorneys, attorney for the Debtor and Jack Sipe Construction Co.] averted

> straight bankruptcy for the Debtor until the recession began to subside and, in so doing, substantially enhanced the value of the real estate and also increased the likelihood of the second lien holders and other creditors receiving equity from a sale of the real estate by generating rent from the improvements to reduce the balances of the first mortgages on the real estate.

The bankruptcy judge further found that under the arrangement payments totalling $545,000 had been made which inured to the benefit of the secured creditors (Pet. App. 5a).

On February 14, 1975, Joe N. Cagle was appointed trustee in bankruptcy. The trustee was ordered (A. 342a-343a):

> to collect and receive all rents * * * and to hold and retain all moneys thus received to the end that the same may be applied under this or different or further orders of this Court.

The trustee originally made payments to the holders of the first trusts. However, pursuant to the bankruptcy judge's order appointing the trustee, the judge directed the trustee not to make any payments on the trusts. The trustee was informed that the rental income would be needed to pay the costs of administration (A. 799a). The trustee notified the holders of both the first and second trusts of the bankruptcy judge's instruction (A. 796a-800a). Petitioner took no steps to appeal the bankruptcy judge's instruction or otherwise move to have the rents sequestered for his benefit, although the mortgage was in default (see Pet. App. 36a-37a).

After the conversion of Chapter XI arrangement to a liquidating bankruptcy, the first meeting of Golden's creditors was held on April 16, 1975. Golden's only asset was the real estate, which was subject to the following trusts and had been appraised at the following values:

Parcel [5]	Appraised Value [6]	Approximate First Mortgage Balance [7]	Indicated Equity
Tract I (referred to also as F. Avenue, S.E. and Metelpel or Mepel Building)	$ 110,000	$ 48,000	$ 62,000
Tract II (referred to also as Office Complex or Shopping Center)	250,000	174,000	76,000
Tract III (referred to also as Continental Supply Facility or 231 Ninth Street Lane, S.E. or Little Street)	360,000	225,000	135,000
Tract IV (referred to also as Tate Boulevard)	953,000	741,000	212,000
Totals	$1,673,000	$1,188,000	$485,000

[Footnotes 5, 6 and 7 on following page]

At the hearing, the trustee stated that Tracts I, II, and III were readily saleable for amounts approaching their appraised values (A. 380a-382a). However, because of the unavailability of financing and the depressed economic conditions in the locality, the trustee believed that the sale of Tract IV (Tate Boulevard) at its appraised value would be difficult (A. 379a). The trustee accordingly outlined (A. 384a-385a) three possible courses of action—(1) sale of the property, (2) abandonment of the property to the holders of the second trusts, and (3) acquiescence in foreclosure proceedings by any of the trust holders. Petitioner urged the second option—a conveyance of the property to the second trust holders. In response, the bankruptcy judge stated (A. 399a-400a):

> I'm not disposed to believe that it would be in the best interest of all the creditors to convey that property to the second mortgage holders * * *. I'll have to take a while to digest that suggestion, and one of the reasons is I'm not sure what the extent of the costs and expenses of administration are and how they should be borne by the creditors.

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[5] This tract breakdown of the real estate follows the description contained in the trustee's deed to petitioner and his wife. See A. 663a-672a.

[6] Mercer Simmons, whom the bankruptcy judge recognized as an expert, appraised the properties (A. 289a, 292a-294a).

[7] The first mortgage balance figures are set forth in the Statement of Assets filed by Golden on March 24, 1975, pursuant to Rule 122 of the Bankruptcy Rules (A. 357a-365a).

The bankruptcy judge and the trustee both believed that the properties would become more saleable in the immediate future because financing was becoming increasingly available and interest rates were declining (A. 402a). Because of these considerations, the bankruptcy judge expressed the opinion that "a little delay" might be helpful (A. 402a).

Accordingly, on June 11, 1975, the trustee filed a complaint in an adversary proceeding "To Sell Real Estate and Transfer Certain Liens to Proceeds of Sale." The complaint sought the sale of the real estate, subject only to the first trusts, and the transfer of the rights of other secured parties (*i.e.*, the second mortgagees) in exchange for the proceeds of sale (A. 421a-433a). Petitioner did not file an answer to the complaint.[8] After an adversary hearing was held on June 30, 1975 (A. 39a),[9] the bankruptcy judge ordered that the sale be held on July 28, 1975. At the ensuing sale, the highest bids on the four tracts were as follows (A. 563a-568a):

Tract I	$43,500
Tract II	28,000
Tract III	75,000
Tract IV	100

The holders of the second trust objected to the sale and requested that the properties be abandoned to

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[8] Answers were filed on behalf of Shelby Savings and Loan Association, Fidelity Savings and Loan Association, First National Bank of Catawba County, and Golden (A. 36a-39a).

[9] No transcript of this proceeding is available.

them.[10] On August 4, 1975, the bankruptcy judge denied this request. The judge confirmed the sales of Tracts I and III and transferred the rights of the holders of the second trusts in exchange for the proceeds of sale (A. 569a-571a). Thereafter, on August 19, 1975, the holders of the second trust moved to amend the judgment and for a rehearing on the confirmation order, again contending that the property should be abandoned to them (A. 612a-631a). In denying the motion, the bankruptcy judge pointed out that the second mortgagees had not appealed from his order of June 30, 1975, in which he ordered the property sold, that the sale had been properly held, and that the bidding on the sales of Tracts I and III was "spirited[ly] competitive * * * although, apparently, none of the second lienholders entered any bids" (A. 641a-644a).

The district court affirmed the bankruptcy judge's order insofar as it directed that the property be sold. However, it vacated the bankruptcy judge's order confirming the sale of Tracts I and III, and ordered a new sale of all four tracts, subject to the first trusts. The district court's order permitted the holders of the second trust "to use the outstanding principal balance of their Deed of Trust to bid" at the resale (A. 655a-657a). The district court further ordered that (A. 656a):

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[10] This objection and the request were apparently orally made.

> If the proceeds of said sale are insufficient in amount to pay the principal balance of $360,-000.00 outstanding on the second Deed of Trust or if the holders of the said second Deed of Trust are not the high bidders within the amount of said principal balance of said second Deed of Trust on all four tracts of land, then the Trustee shall forthwith abandon the said real estate.

The four tracts were resold on November 12, 1975. On that date, Jack Sipe Construction Company and McKaughn assigned their rights under the second deed of trust to petitioner and his wife (A. 674a-688a). Petitioner bid in all four tracts for $174,000 (Pet. App. 33a) and, on November 20, 1975, the trustee conveyed these properties to petitioner and his wife. The deed from the trustee specifically provided that (A. 672a-673a):

> The accrued rents and the right to collect unpaid accrued rents from the above-described tracts of real estate are hereby expressly not conveyed, but are reserved to the Grantor [the trustee].

Petitioner accepted the deed from the trustee (Pet. App. 32a-33a).

In the meantime, from February 14, 1975 (date of the adjudication of bankruptcy), to November 20, 1975 (date of the conveyance of the properties), the trustee collected $157,348.80 in rents from the four tracts, and paid approximately $2,973.26 of expenses directly relating to the properties (A. 349a, 368a,

409a, 414a, 434a, 466a, 607a, 645a, 649a, 695a).[11] The fund derived from these rents is the subject of this litigation.

3. *The Present Controversy Over Accrued Rents.* On July 1, 1975, petitioner filed a proof of claim in bankruptcy as a secured creditor in which he stated "[t]hat claimant does not hold * * * any security for the debt * * * for the claimant's use except *Note and Deed of Trust dated July 1, 1974* * * *" (emphasis in original) (A. 443a). At the time petitioner presented his claim, the trustee had collected and held over $82,000 in rents (A. 436a).[12] Notwithstanding his earlier failure to claim any security interest other than his note, on December 1, 1975, petitioner filed a Motion for Distribution of Funds in which he claimed that "as secured creditor and valid holder of all right, title and interest to the second mortgages * * *, [he] is entitled to a substantial portion of those accumulated rents and profits * * * held by the [trustee]" (A. 692a). The trustee objected to the claim (A. 733a-736a). At this time, the balance of the cash on hand held by the trustee was $162,-971.32 (Pet. App. 32a), which would have been almost exhausted by petitioner's claim.

The bankruptcy judge rejected petitioner's claim to the accrued rents (Pet. App. 20a). He noted that

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[11] The expense figures are taken from the total monthly cash disbursements, less items that do not appear to be directly related to the management of the real estate.

[12] Previously, on July 12, 1973, and February 4, 1974, the United States had filed proofs of claims for taxes as a priority creditor (A. 95a-99a, 197a-201a).

the original basis for petitioner's claim was the second deed of trust in the amount of $360,000, that petitioner had bid in the property for the amount of $174,000, and that "none of the funds in the hands of the Trustee were derived from the sale of the collateral." The bankruptcy judge therefore disallowed the $186,000 difference between the original amount of the second trust ($360,000) and the bid-in price ($174,000) as a secured claim (Pet. App. 16a-17a). However, the bankruptcy judge allowed the $186,000 difference to be treated as a general unsecured claim (Pet. App. 17a). The court also allowed the claims for fees and expenses of the trustee and of the attorneys for the creditors' committee and the debtor (Golden) and ordered that these expenses be paid from the fund in the hands of the trustee (Pet. App. 17a-18a).

Petitioner sought review of the bankruptcy judge's order in the district court. After a hearing, the trustee and the attorney for the creditors' committee filed an uncontradicted affidavit in which they stated that petitioner's "out of pocket" investment in the second mortgage was $272,200 rather than the face amount of the mortgage, $360,000 (A. 780a). They further pointed out that shortly after his purchase of the property, petitioner had refinanced Tracts I-III as shown below (A. 778a-779a):

	Refinanced Amounts	First Trust or Mortgage	Costs of Refinancing	Excess Cash Received over First Trust or Mortgage after Costs
Tract I (Metelpel Building)	$ 85,000.00	$ 48,520.51	$ —	$36,479.49
Tract II (Shopping Center)	212,000.00	191,965.76	975.00	28,034.24
Tract III (Continental Systems)	290,000.00	223,532.50	5,000.00	66,467.50

The affidavit also stated that on April 7, 1976, petitioner had sold a portion of Tract IV for $1,000,000, and that, after payments of the first mortgage, accrued taxes and expenses, he received a net amount of $162,049.06 (A. 777a). In addition, he retained a five-acre portion of Tract IV, which had been appraised at $50,000 (A. 779a). The affidavit concluded that, assuming the value of the property to be equal to the refinanced amounts, the value of the property petitioner received in the sale to him was substantially greater than the $174,000 bid price. Thus, petitioner apparently realized a profit on the properties received from the trustee (A. 781a). The facts alleged in the trustee's affidavit were not contested.

The district court reversed the order of the bankruptcy judge and held that petitioner's "secured status extend[ed] to the rents and profits derived from the property during the administration of the bankrupt's estate" (Pet. App. 29a). The court found that petitioner had done "all that he could do to obtain

possession of the property and proceed to foreclosure as well as to have the rents collected and sequestered" (Pet. App. 28a). The court further found that equity required that all the "rents * * * should go to * * * [petitioner] rather than to the unsecured creditors" (Pet. App. 28a). The court therefore remanded the case to the bankruptcy judge to determine what portion of the claimed expenses were reasonably incurred in the preservation of these properties (Pet. App. 29a).

The court of appeals, with one judge dissenting, reversed and remanded the case for reinstatement of the bankruptcy judge's order (Pet. App. 32a).[13] The court found that petitioner had not taken the necessary action to insure that the rents would be collected and sequestered for his benefit (Pet. App. 37a). It therefore held that petitioner was not en-

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[13] The appeal from the district court's order was taken by the trustee, the creditors' committee, the debtor and the United States. The interest of the United States derives from the trustee's interest. The claim of the United States (A. 471a) for unpaid employment taxes is for approximately $50,000 and has a priority under Section 64a(4) of the Bankruptcy Act (11 U.S.C. 104(a)(4)). The sole asset from which the United States can obtain satisfaction of its claim is the fund in the hands of the trustee derived from the rents obtained after the adjudication of bankruptcy. If, as the district court held, petitioner's security extended to these rents, the government's claim, as well as those for administration expenses, will not be satisfied. On the other hand, if, as the bankruptcy court and the court of appeals held, petitioner had no security interest in the rents, funds will be available, after payment of administration expenses, to satisfy the government's tax claim at least in part.

titled to the rents that accrued during the bankruptcy proceeding under the terms of the mortgage. In so holding, the court noted that while petitioner had made several informal requests to the bankruptcy judge that the property be abandoned to him, he pursued the matter no further when the judge refused to grant these requests. Indeed, when petitioner made one of these requests for abandonment at a time when the trustee had collected approximately $50,000 in rents, he specifically waived any claim to the accrued rents. Moreover, when the trustee formally sought authority to sell the property, petitioner was made an adversary party to the request. However, he failed to file an answer, although he could have requested either abandonment, permission to foreclose under state law, or a determination of the priority of his lien on the rents (Pet. App. 37a). The court of appeals concluded, "[i]n short, we can find no sufficient indicia that [petitioner] would have proceeded to assert a security interest in the rents had bankruptcy not ensued" (*ibid.*).

The court of appeals also rejected the district court's application of "equitable principles" in determining the entitlement to the rents (Pet. App. 35a). The court stated that even "[i]f equity has a part in the resolution of a question of this type—an issue upon which we express no view—equity does not supply the answer here" (Pet. App. 38a).

SUMMARY OF ARGUMENT

1. While the Bankruptcy Act contains detailed provisions governing the priority and payment of unsecured claims, it provides no comparable rules with respect to distributions to secured creditors. Once a debtor is adjudicated a bankrupt and a trustee is appointed, any liens that are valid against the debtor at that time are also valid against the trustee unless they can be set aside under other provisions of the Act. Thus, for the purposes of the Bankruptcy Act, the trustee steps into the shoes of the debtor and is subject to the claims of secured creditors to which the debtor would otherwise have been subject had bankruptcy not occurred.

The question as to what constitutes a valid security is not a matter of federal bankruptcy law; rather it turns on the commercial law of the particular state. The correctness of this proposition is confirmed not only implicitly by the structure of the Bankruptcy Act but also explicitly by an unbroken line of decisions of this Court which hold that the nature and extent of a creditor's security interest in a bankruptcy proceeding is determined by reference to state law. See, *e.g.*, *Hiscock* v. *Varick Bank of New York*, 206 U.S. 28 (1907); *Stellwagen* v. *Clum*, 245 U.S. 605, 613 (1918).

Once it is recognized that the fact of bankruptcy does not alter the nature and extent of secured claims against the debtor, the correctness of the decision of the court of appeals becomes readily apparent. The court held that petitioner, a second mortgagee of

real property, was not entitled to rents accruing during the period from the initiation of liquidation proceedings to the foreclosure sale of such property. Since the Bankruptcy Act does not provide substantive rules with respect to the priority accorded secured creditors, the fact of the mortgagor's bankruptcy is analytically irrelevant in determining whether petitioner would be entitled under state law to the rents produced by the property during bankruptcy. Therefore, the proper question to be determined under state law is whether a mortgagee such as petitioner is entitled to accrued rents upon the default of the mortgagor.

Here, the relevant state law (North Carolina) provides that a mortgagee is not entitled to the rents until he either takes possession of the property or has a receiver appointed to collect the rents for his benefit. Petitioner did neither; indeed, he took no affirmative action that fairly could be regarded as asserting a claim to the rents until after he purchased the property at the foreclosure sale. In these circumstances, petitioner would not have been entitled under state law to the rents if bankruptcy had not occurred, and the bankruptcy of the mortgagor did not create any additional rights in favor of petitioner's security in the property.

2. In holding that petitioner was not entitled to the rents because he did not have a security interest in them under North Carolina law, the decision below is in accord with four other courts of appeals (the Second, Sixth, Eighth and Ninth Circuits) which have

ruled that state law governs a mortgagee's right to rents earned during bankruptcy. *In re Brose*, 254 F. 664 (2d Cir. 1918); *Tower Grove Bank & Trust Co.* v. *Weinstein*, 119 F.2d 120 (8th Cir. 1941); *In re Hotel St. James Co.*, 65 F.2d 82 (9th Cir. 1933). See also *In re American Fuel & Power Co.*, 151 F.2d 470, 481 (6th Cir. 1945). Those decisions are consistent with the established policy of the Bankruptcy Act that state law determines the validity of the interests of secured creditors. By applying state law in determining a mortgagee's right to rents, these authorities insure that the outcome will be the same whether the mortgagee's claim is raised in a federal bankruptcy proceeding, a state court receivership, or an action for foreclosure. Such uniformity of result discourages forum shopping and prevents "a windfall merely by reason of the happenstance of bankruptcy." *Lewis* v. *Manufacturers Nat. Bank*, 364 U.S. 603, 609 (1961).

Moreover, the procedure applicable to the claims of a secured creditor under the Bankruptcy Act is in all significant respects parallel to his rights and remedies under North Carolina law. If bankruptcy had not intervened and the amount bid in by petitioner at the foreclosure sale did not fully satisfy the amount due on his debt, petitioner would have been entitled to pursue the debtor for a deficiency judgment for the balance of the debt. But this deficiency judgment would not be entitled to any priority over other general unsecured claims until docketed. Until then it would be a claim against the debtor's

other property in the same manner as any other general unsecured claims and would share in that property on a pro rata basis.

Here, Section 57h of the Bankruptcy Act (11 U.S.C. 93(h)) requires a similar result. Pursuant to that provision, the bankruptcy court determined the value of the security held by petitioner "by converting the same into money according to the terms of the agreement," *i.e.*, it sold the property at a foreclosure sale. It thereafter credited "the amount of such value * * * upon [petitioner's claim]" and allowed the difference as an unsecured claim against the bankrupt estate. In short, Section 57h, like state law, contemplates a sale of the security as described in the instrument upon which the creditor bases his claim. Since petitioner took no steps to obtain the incidents of ownership (*i.e.*, the rents) prior to the foreclosure sale, his security interest is necessarily limited to the value obtained at the sale.

Finally, the requirement that the mortgagee take affirmative action, consistent with state law, to secure an interest in the rents furthers a more orderly and certain administration of the bankruptcy estate. Such a requirement provides both the bankruptcy court and the parties with early notice of the nature and extent of the mortgagee's claim and enables the court to take that claim into account prior to any sale of the property.

3. The minority line of decisions (of the Third and Seventh Circuits) rejecting the application of

state law in favor of "equitable considerations" are based upon the erroneous premise that bankruptcy destroys the mortgagee's remedies under state law without providing an equivalent remedy in bankruptcy. *Bindseil* v. *Liberty Trust Co.*, 248 F. 112 (3d Cir. 1917); *In re Pittsburgh-Duquesne Development Co.*, 482 F.2d 243 (3d Cir. 1973); *In re Wakey*, 50 F.2d 869 (7th Cir. 1931). But the mortgagee's remedies in the bankruptcy court are similar to those that would have been available to him in a state court. For example, while the mortgagee can gain possession of the property by consent or judicial action under state law, the trustee can accomplish the same result in bankruptcy by abandoning the property to the mortgagee. If the trustee refuses, the mortgagee can litigate the question and can seek the appointment of a trustee to sequester the rents for his benefit. Thus, contrary to the assumption of the minority view, bankruptcy does not cut off the mortgagee's remedies so as to require an "equitable" adjustment of the rights of the parties.

4. a. Even on the assumption that the court of appeals correctly concluded that the question of the mortgagee's entitlement to rents was governed by state law, petitioner errs in contending that he took sufficient action during the bankruptcy proceeding to gain a security interest in the rents under North Carolina law. Petitioner relies upon an order of the bankruptcy court appointing an agent to collect the rents during the Chapter XI arrangement that preceded the bankruptcy. But this agent was not ap-

pointed to collect the rents solely for petitioner's benefit. The record undisputably shows that the appointment of the agent was nothing more than an administrative device employed by the court to facilitate collection of the rents for the benefit of all of the creditors.

b. Finally, petitioner would not be entitled to the rents even under the minority line of decisions which rejects the application of state law in favor of equitable principles. Under the minority view, the mortgagee is not entitled to the rents unless he establishes that "the mortgaged property was worth less than the mortgaged indebtedness." *In re Cigar Stores Realty Holdings*, 69 F.2d 823, 824 (2d Cir. 1934). Here, petitioner has not established the existence of a deficiency between his debt and the value of the property. Indeed, the record establishes that the value of his security over his investment was approximately $70,000. In these circumstances, the court of appeals correctly concluded (Pet. App. 38a) that even "[i]f equity has a part in the resolution of a question of this type * * * equity does not supply the answer here."

ARGUMENT

PETITIONER IS NOT ENTITLED TO THE RENTS PRODUCED BY GOLDEN'S REAL PROPERTY DURING THE PERIOD FROM THE INITIATION OF LIQUIDATION PROCEEDINGS TO THE FORECLOSURE SALE OF THE PROPERTY

The question presented in this bankruptcy case is whether petitioner, a second mortgagee of real property, was entitled to the rents produced by the property during the period from the initiation of liquidation proceedings to the foreclosure sale of such property. As the court of appeals properly observed (Pet. App. 34a-35a), the question of a secured creditor's right to income, generated by the secured property during bankruptcy, has produced a conflict in the circuits. In accord with the decision below, the Second, Sixth, Eighth and Ninth Circuit have held that the mortgagee has no right to the rents once the bankruptcy court assumes control of the property, unless he petitions the bankruptcy judge for a sequestration order, obtains the appointment of a receiver to collect the rents, or secures the bankruptcy judge's consent to foreclosure. *In re Brose*, 254 F. 664 (2d Cir. 1918); *Tower Grove Bank & Trust Co.* v. *Weinstein*, 119 F.2d 120 (8th Cir. 1941); *In re Hotel St. James Co.*, 65 F.2d 82 (9th Cir. 1933). Accord: *In re American Fuel & Power Co.*, 151 F.2d 470, 481 (6th Cir. 1945). See also *Fidelity Bankers Life Insurance Co.* v. *Williams*, 506 F.2d 1242, 1243 (4th Cir. 1974). Under this approach, the primary focus in determining the entitlement of a mortgagee to rents is the

nature of his interest in state law, the terms of the mortgage and the acts of the parties. The rationale for this majority view is that the rights and duties of the parties are not altered by bankruptcy. However, the bankruptcy court supersedes the state court as the proper forum for protecting the interests of creditors and determining whether the mortgagee has a security interest in the rents under state law.

The contrary line of authority is the minority view of the Third and Seventh Circuits. See *Bindseil* v. *Liberty Trust Co.*, 248 F. 112 (3d Cir. 1917); *In re Pittsburgh-Duquesne Development Co.*, 482 F.2d 243 (3d Cir. 1973); *In re Wakey*, 50 F.2d 869 (7th Cir. 1931). Those courts have held that the mortgagee may recover the rents if he can establish an equitable basis for his claim. The rationale for these decisions is that the rights of both the secured and unsecured creditors are fixed at the adjudication of bankruptcy and the bankruptcy divests the mortgagor's possession of the realty. Under this minority view, the rents arising thereafter belong to the mortgagee and should not be diverted to the general creditors. The Third and Seventh Circuits regard the rents as belonging to the mortgagee as a matter of equity "to vindicate its own right of property." *In re Pittsburgh-Duquesne Development Co., supra*, 482 F.2d at 246. However, the mortgagee cannot recover the rents arising during bankruptcy unless he establishes that "the mortgaged property was worth less than the mortgaged indebtedness." *In re Cigar Stores Realty Holdings*, 69 F.2d 823, 824 (2d Cir. 1934).

We submit that the majority view of five circuits (the Second, Sixth, Eighth and Ninth Circuits, as followed by the court below) is more compatible with the purposes of the Bankruptcy Act and should be established by this Court as the uniform rule. When a liquidating bankruptcy occurs, the trustee takes title to the interests in property of the bankrupt. While the Bankruptcy Act accords priority to certain unsecured creditors (*e.g.*, administration expense creditors) over general unsecured creditors, it generally does not alter the rights of secured creditors as those rights are determined under state law. Here, if bankruptcy had not occurred, petitioner, as a second mortgagee of the bankrupt's real property, would not have been entitled under state law to the rents produced by the property, unless he had obtained possession of the property, or, upon foreclosure, obtained the appointment of a receiver to sequester the rents for his benefit. Petitioner did not take any of these necessary steps and the bankruptcy of the mortgagor did not create any additional rights in favor of petitioner's security interest in the property. Hence, he is not entitled to the rents accruing during bankruptcy. However, before describing the extent of petitioner's rights under state law, we first set forth for the Court the treatment of creditors in a liquidating bankruptcy.

A. The Rights Of Secured Creditors In A Liquidating Bankruptcy Are Determined Under State Law

The primary purpose of a liquidating bankruptcy is to provide for the orderly and equitable distribu-

tion of the bankrupt's assets to his creditors. *Bruning* v. *United States*, 376 U.S. 358 (1964); *Williams* v. *U. S. Fidelity Co.*, 236 U.S. 549, 554-555 (1915); *Sampsell* v. *Imperial Paper Corp.*, 313 U.S. 215, 219 (1941); 3 *Collier on Bankruptcy* § 60.01, at 743 (14th ed.). The legal representative of the bankrupt's creditors is the trustee, who is appointed to collect and distribute the assets of the bankrupt. See Sections 44 and 45 of the Bankruptcy Act (11 U.S.C. 72 and 73). Pursuant to Section 70a of the Act (11 U.S.C. 110(a), App., *infra*, 9a-12a), the trustee is vested by operation of law as of the date of the filing of the bankruptcy petition with the title of the bankrupt to all of his nonexempt property. The trustee's title carries with it the right to possession only for purposes of administration and distribution of the estate among the bankrupt's creditors. 4A *Collier*, *supra*, § 70.04, at 49-51. However, Section 70a "does not vest the trustee with any better right or title to the bankrupt's property than belong to the bankrupt or his creditors at the time when the trustee's title accrues." *Hewit* v. *Berlin Machine Works*, 194 U.S. 296, 302 (1904).

The general theory underlying the Bankruptcy Act is equality of distribution among the bankrupt's general unsecured creditors whose claims are proved and allowed. See Sections 57 and 63 of the Act (11 U.S.C. 93 and 103). Thus, the liquidation provisions of the Act (Sections 1-72, 11 U.S.C. 1-112) seek the distribution of the bankrupt's unencumbered assets (except exempt property) among his general unsecured creditors, with certain of those creditors given a priority.[14] The Act establishes the "date of bankruptcy," *i.e.*, the date when the petition in bankruptcy is filed, as the time for determining which of the bankrupt's assets are unencumbered and who are the general creditors. However, because it would be relatively easy for the creditors to encumber or attach the debtor's assets in anticipation of the debtor's filing a petition in bankruptcy and thereby defeat the claims of the general unsecured creditors in the ensuing liquidation proceeding, the Act provides for the invalidation of certain pre-bankruptcy transfers even though such transfers might be otherwise valid under state law. See generally 3 *Collier*, *supra*, § 60.01, at 743-744.

First, Section 70c (11 U.S.C. 110(c), App., *infra*, 12a-13a) gives the trustee the power to strike down secret liens and transfers. See *United States* v. *Speers*, 382 U.S. 266, 275 (1965); 4B *Collier*, *supra*, §§ 70.46, 70.48, at 559, 585-586. Second, Section 60a and b (11 U.S.C. 96(a) and (b)) give the trustee the power to void, as preferences, certain transfers made by the bankrupt within four months of bankruptcy. Third, Section 67a and d (11 U.S.C.

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[14] Section 64a of the Act (11 U.S.C. 104(a)) prescribes the order of priority for the payment of the claims of the general unsecured creditors. It accords a first priority to the costs and expenses of administration of bankruptcy and a fourth priority to "taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy * * *." See generally 3A *Collier*, *supra*, § 64.02[1], at 2063-2065.

107(a) and (d)) invalidate certain liens against a bankrupt's property obtained through a judicial proceeding within four months of bankruptcy and certain fraudulent transfers made within one year of bankruptcy. Finally, Section 70e (11 U.S.C. 110(e)) invalidates any transfer deemed fraudulent under federal or state law. See generally 3 *Collier*, *supra*, § 60.01, at 744-746.

While the Bankruptcy Act contains detailed provisions governing the priority and payment of unsecured claims (see Section 64a, 11 U.S.C. 104(a)), it provides no comparable rules with respect to distributions to secured creditors. The Act addresses the status of secured creditors only in the context of according the trustee the power to set aside certain secured transfers that are inequitable to the unsecured general creditors. See Sections 60, 67, and 70 of the Act; cf. 4 *Collier*, *supra*, § 67.02[1], at 19-43.[15] Thus, Section 1(28) of the Act (11 U.S.C. 1(28)) defines a "secured creditor" in general terms to include "a creditor who has security for his debt upon the property of the bankrupt of a nature to be assignable under this title * * *." But the question of what constitutes a valid security, or the extent of such security, is not a matter of federal bankruptcy law;

[15] There is an exception for statutory liens in favor of employees, contractors, mechanics, or any other class of persons, and statutory liens for taxes and debts owed to the United States or to any state created under federal or state law. Such liens may be valid against the trustee even though they may arise or be perfected within four months of bankruptcy. See Section 67b of the Act, 11 U.S.C. 107(b).

rather, it turns on the commercial law of the particular state.

The correctness of this proposition is confirmed not only implicitly by the structure of the Bankruptcy Act but also explicitly by an unbroken line of decisions of this Court, which hold that the nature and extent of a creditor's security interest in a bankruptcy proceeding is determined by reference to state law. In *Hiscock* v. *Varick Bank of New York*, 206 U.S. 28 (1907), the Court upheld the validity of a lien upon assets held by a bankrupt and rejected the trustee's claim that the Bankruptcy Act deprived the lienor of any remedy otherwise provided by state law. As the Court stated, "[t]he contracts of pledge were made, executed and to be performed in the State of New York, and the rights of the parties were governed by the law of that State. No preference under the Bankruptcy Act was alleged or proved, nor was there any allegation or proof that the pledge of the securities was in fraud of the rights of the creditors or trustee. The questions of the extent and validity of the pledge were local questions, and the decisions of the courts of New York are to be followed by this court" (*id.* at 37-38). As the Court subsequently explained in *Stellwagen* v. *Clum*, 245 U.S. 605, 613 (1918) (emphasis supplied):

> The Federal Constitution, Article I, § 8, gives Congress the power to establish uniform laws on the subject of bankruptcy throughout the United States. In view of this grant of authority to the Congress it has been settled from an early date that state laws to the extent that they conflict

with the laws of Congress, enacted under its constitutional authority, on the subject of bankruptcies are suspended. While this is true, state laws are thus suspended only to the extent of actual conflict with the system provided by the Bankruptcy Act of Congress. *Sturges* v. *Crowninshield*, 4 Wheat. 122; *Ogden* v. *Saunders*, 12 Wheat. 213.

Notwithstanding this requirement as to uniformity the bankruptcy acts of Congress may recognize the laws of the State in certain particulars, although such recognition may lead to different results in different States. For example, *the Bankruptcy Act recognizes and enforces the laws of the States affecting dower, exemptions, the validity of mortgages, priorities of payment and the like.* Such recognition in the application of state laws does not affect the constitutionality of the Bankruptcy Act, although in these particulars the operation of the act is not alike in all the States. *Hanover National Bank* v. *Moyses*, 186 U.S. 181, 188, 189, 190.

Accord: *Thompson* v. *Fairbanks*, 196 U.S. 516, 522 (1905); *Humphrey* v. *Tatman*, 198 U.S. 91, 93-95 (1905); *York Manufacturing Co.* v. *Cassell*, 201 U.S. 344, 352 (1906); *Thompson* v. *Magnolia Co.*, 309 U.S. 478, 483-484 (1940); *Lewis* v. *Manufacturers Nat. Bank*, 364 U.S. 603, 607-609 (1961). See also *Louisville Bank* v. *Radford*, 295 U.S. 555, 590 (1935).

Accordingly, a determination of petitioner's rights to the rents accruing during bankruptcy requires an investigation of the state law governing his mortgage. We turn, therefore, to the law of North Carolina.

B. Under North Carolina Law, Petitioner Would Not Be Entitled To The Rents Upon The Default Of Golden Upon The Mortgage Unless He Took Possession Of The Property Or Obtained The Appointment Of A Receiver To Sequester The Rents Prior To A Foreclosure Sale

1. The mortgage in this case took the form of a deed of trust (A. 445a). Under North Carolina law, the trustee under a deed of trust has bare legal title to the property solely for the purpose of securing the mortgagor's obligation to the mortgagee.[16] *Walston* v. *Twiford*, 248 N.C. 691, 10 S.E.2d 62 (1958); *Gregg* v. *Williamson*, 246 N.C. 356, 358, 359, 98 S.E.2d 481, 484 (1957). This is the applicable rule in most states. See *Osborne on Mortgages* § 17, at 26 (1970). Thus, subject to petitioner's rights to the security in the property under the deed, Golden "is 'considered as the owner of the land'" (*Gregg* v. *Williamson*, *supra*, 246 N.C. at 360, 98 S.E.2d at 485), and petitioner was not entitled to possession of

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[16] Under North Carolina law, and in general, the major difference between a mortgagee with a power of sale and a deed of trust is that a deed of trust vests bare legal title in an independent trustee who has the power of sale exercisable upon default and at the request of the mortgagee. See *Oil Co.* v. *Baars*, 224 N.C. 612, 615, 31 S.E.2d 854 (1944). Although the creditor and debtor are technically in a cestui que trust relationship, they are nevertheless generally referred to as mortgagee and mortgagor. See *Mills* v. *Building & Loan Association*, 216 N.C. 664, 6 S.E.2d 549 (1940); *Richmond Mortgage & Loan Corp.* v. *Wachovia Bank & Trust Co.*, 300 U.S. 124 (1937) (discussing North Carolina law, as applied to a deed of trust); *Osborne*, *supra*, § 17, at 26. Thus, the differences between a mortgagee with a power of sale and a deed of trust are not material in this case.

the property until default of the mortgage contract occurred (*Brannock* v. *Fletcher*, 271 N.C. 65, 155 S.E. 2d 532 (1967); *Gregg* v. *Williamson*, *supra*, 246 N.C. at 359, 98 S.E.2d at 484).[17] See also *Kistler* v. *Development Co.*, 205 N.C. 755, 172 S.E. 413 (1934); *Killebrew* v. *Hines*, 104 N.C. 182, 10 S.E. 159 (1889). Once a default occurred, petitioner became entitled under North Carolina law to possession of the property, which he could accomplish either by obtaining the consent of Golden or by an action in ejectment. *Brannock* v. *Fletcher*, *supra*. See, generally, 4 *American Law of Property* § 16.80, at 150 (1952). However, even though petitioner could obtain possession of the property prior to foreclosure, Golden's

[17] There are three different theories of mortgage law: title, intermediate, and the lien theory. In title states, the mortgagee has the right to possession even prior to default, subject to the mortgagor's rights to defeat the mortgagee's interest upon the discharge of his obligation. However, if the mortgagee takes possession, he is under a strict duty to account for rents and profits during this period of possession. See page 34, *infra*. In intermediate states, the mortgagee has no right to possession until the mortgagor defaults. Finally, in a lien jurisdiction, the mortgagee's interest is a security interest and the mortgagor is entitled to retain possession after default and until foreclosure. See *Osborne*, *supra*, §§ 14-15, at 32-34. While North Carolina is sometimes classified as a title state (see Comment, *The Mortgagee's Right to Rents After Default*, 50 Yale L. J. 1424, 1425, n.6 (1941)), its case law suggests that it is an intermediate state. These theoretical differences among the states do not appear to warrant significantly different results in the rights of the parties, nor are they relevant for purposes of the question presented in this case. See Berick, *The Mortgagee's Rights to Rents*, 8 U. Cinn. L. Rev. 250 (1934).

interest or "equity of redemption" could only be terminated by a foreclosure sale.[18] See, generally, *Osborne*, *supra*, § 339, at 727; § 337, at 724.

While petitioner was entitled to seek possession of the mortgaged property after Golden's default and prior to foreclosure, as long as Golden remained in possession—even after its default—it, and not petitioner, was entitled to the rents and profits generated by the property. *Gregg* v. *Williamson*, *supra*, 246 N.C. at 360, 98 S.E.2d at 485; *Kistler* v. *Development Co.*, *supra*. This aspect of North Carolina law is in

[18] See §§ 45-21.1 *et seq.* and §§ 1-339.1 *et seq.*, N.C. Gen. Stat. (1976 Repl.).

If the proceeds from a foreclosure sale do not satisfy the mortgage indebtedness, the mortgagee is generally entitled to institute an in personam action against the mortgagor and obtain a deficiency judgment for the difference. See *Osborne*, *supra*, § 333, at 975. The deficiency judgment becomes a lien on other real estate owned by the debtor only at the time it is docketed (see § 43-45, N.C. Gen. Stat. (1976 Repl.), and may be enforced by execution and sale (§ 1-309, N.C. Gen. Stat. (1976 Repl.).

Under North Carolina law, there are two limitations on the mortgagee's ability to obtain such relief. First, if the mortgagee is the purchaser pursuant to a sale under power in the deed, the mortgagor can defeat the deficiency claim, in whole or in part, by showing that "the property sold was fairly worth the amount of the debt secured by it at the time * * * or that the amount bid was substantially less than its true value." § 45-21.36, N.C. Gen. Stat. See *Richmond Mortgage & Loan Corp.* v. *Wachovia Bank & Trust Co.*, *supra*. The law of North Carolina also bars a deficiency judgment if the trust instrument reflects that the trust was created "to secure to the seller [of the property] the payment of the balance of the purchase price of real property." § 45-21.38, N.C. Gen. Stat.

accord with the general rule that the rents and profits are incidents of possession. See *Freedman's Saving Co.* v. *Shepherd*, 127 U.S. 494 (1888); II *Glenn on Mortgages* §§ 170, 180, at 908, 939 (1943); 2 *Wiltsie on Mortgage Foreclosure* § 560, at 908 (1939). Moreover, petitioner had "no right to possession except to assure payment of the debt or performance of other conditions of the mortgage." *Gregg* v. *Williamson*, *supra*, 246 N.C. at 359, 98 S.E.2d at 484. See also *Kistler* v. *Development Co.*, *supra*. Thus, if petitioner had taken possession, he would be chargeable to the trustee for an accounting of the rents and profits arising after his assumption of possession, and would have had a further duty to apply the rents and profits to the debt and to account to the trustee for any surplus. See *Brannock* v. *Fletcher*, *supra*; *Anderson* v. *Moore*, 233 N.C. 299, 63 S.E.2d 641 (1951). See generally, *Osborne*, *supra*, § 167, at 288.

In addition to taking possession, the mortgagee has another remedy under North Carolina law if the mortgagor is insolvent and the security is inadequate to satisfy the debt. In these circumstances, the mortgagee, after instituting foreclosure, could seek the appointment of a receiver to collect the rents. The receiver would then take possession of the property under the supervision of the court and would likewise be accountable to both the mortgagee and the mortgagor. See *Kistler* v. *Development Co.*, *supra*; *Parker Co.* v. *Bank*, 204 N.C. 432, 168 S.E.2d 681 (1933). See generally, 2 *Wiltsie*, *supra*, §§ 561-562,

at 912-913, 917-918; Berick, *supra*, 8 U. Cinn. L. Rev. at 279.

2. Applying the foregoing rules of North Carolina law to the facts of this case, it is clear that petitioner was not entitled to the accrued rents. Since the Bankruptcy Act does not provide substantive rules with respect to the priority accorded secured creditors, the fact of Golden's bankruptcy is analytically irrelevant in determining whether petitioner would be entitled under state law to the rents produced by the property during bankruptcy. Therefore, the proper question to be determined under state law is whether a mortgagee such as petitioner is entitled to accrued rents upon the default of the mortgagor.

Once Golden defaulted on the mortgage, petitioner either could have sought a judicial sale of the property or a sale by the independent trustee under the deed of trust to recover the debt owed to him. However, North Carolina law provides that a mortgagee must take possession of the mortgaged property or have a receiver appointed to sequester the rents for his benefit in order to gain a security interest in the rents. To be sure, the ensuing bankruptcy prevented petitioner from taking actual possession of the property. But petitioner took no steps in the bankruptcy proceeding that could be deemed equivalent under North Carolina law to taking possession of the property. He neither sought the appointment of a receiver to sequester the rents for his benefit nor claimed that the rents belonged to him. Quite the contrary, in seeking the abandonment of the property

to him at a time when the accrued rents were approximately $50,000, petitioner specifically stated that he would waive any claim to the accrued rents (see Pet. App. 37a). Since petitioner did nothing that would have accorded him a security interest in the rents under North Carolina law had there been no bankruptcy, his claim deserves no different treatment in this federal bankruptcy proceeding. In either forum, petitioner has no security interest in the rents in derogation of Golden's general unsecured creditors.

C. The Majority Line Of Decisions Holding That State Law Governs A Mortgagee's Right To Rents During Bankruptcy Is In Accord With The Established Policy Of The Bankruptcy Act That State Law Determines The Validity Of The Interests Of Secured Creditors

As we have pointed out (*supra*, pages 25-27), once a debtor is adjudicated a bankrupt and a trustee is appointed, the trustee acquires title to all of the bankrupt's property. However, the trustee acquires only "the title of the bankrupt as of the date of the filing of the petition initiating [the bankruptcy] proceeding" (Section 70a of the Act, 11 U.S.C. 110(a)) so that any liens that are valid against the debtor at that time are also generally valid against the trustee. Thus, for purposes of the Bankruptcy Act, the trustee steps into the shoes of the debtor and generally is subject to the claims of secured creditors to which the debtor would otherwise have been subject had no bankruptcy occurred.

1. Once it is recognized that the fact of bankruptcy does not alter the nature and extent of secured claims against the debtor, the soundness of the majority view of the Second, Eighth and Ninth circuits, adopted by the court below, that state law governs a mortgagee's right to rents during bankruptcy becomes apparent. *In re Brose, supra; Tower Grove Bank & Trust Co.* v. *Weinstein, supra; In re Hotel St. James Co., supra.*[19] See also *In re American Fuel & Power Co., supra,* 151 F.2d at 481. Since the Bankruptcy Act does not provide substantive rules for determining the validity of liens against the debtor, there is no overriding policy that would support the establishment of a federal rule with respect to the mortgagee's right to rents during bankruptcy. Like the law of real property generally, the law with respect to the rights and remedies of parties to a mortgage is rooted in the state where the property is located and should not vary according to whether enforcement of the mortgage is sought in a federal or state court. Indeed, the application of state law by the federal courts is an inherent characteristic of our federal system. Cf. *Erie R. Co.* v. *Tompkins,* 304 U.S. 64 (1938). By applying state law in determin-

[19] See also *Petition of Cox,* 15 F.2d 764 (1st Cir. 1926), and *Merchants' and Mechanics' Bank* v. *Sewell,* 61 F.2d 814 (5th Cir. 1932), both of which held that the mortgagee was entitled to rents during bankruptcy because he had a security interest in them under state law. However, both decisions cited *Bindseil* v. *Liberty Trust Co.,* 248 F. 112 (3d Cir. 1917), which held that the mortgagee was entitled to the rents without regard to whether he had a security interest under state law (see pages 43-44, *infra*).

ing a mortgagee's right to rents, the bankruptcy court insures that the outcome will be the same whether the mortgagee's claim is raised in a federal bankruptcy proceeding, a state court receivership, or an action for foreclosure. Such uniformity of result discourages forum shopping by both the debtor and his creditors, encourages uniformity in the administration of the law of the state, and prevents "a windfall [to the secured creditors at the expense of the unsecured creditors] merely by reason of the happenstance of bankruptcy" *Lewis* v. *Manufacturers Nat. Bank, supra*, 364 U.S. at 603.

2. Moreover, the procedure applicable to the claims of a secured creditor under the Bankruptcy Act is in all significant respects parallel to his rights and remedies under North Carolina law. Because the property was in possession of the trustee, petitioner had three available courses of action, *viz.*, (1) to rely on his security in the property and not file a claim with the bankruptcy court; (2) to surrender his security and prove his entire claim as an unsecured creditor; or (3) to prove his claim as secured to the extent of his security and file a claim as an unsecured creditor with respect to the balance. See *United States Bank* v. *Chase Bank*, 331 U.S. 28, 35 (1947); 3 *Collier, supra*, § 57.07[3], at 169-183. Petitioner chose the third alternative and filed a claim as a secured creditor,[20] thereby subjecting himself to the

[20] If it is determined that there is no equity in the property, the trustee may abandon it to the secured creditors. See 4A *Collier, supra*, § 70.42, at 499. Both the trustee and the bankruptcy court rejected this course of action because the appraisal of the property indicated that the debtor had a substantial equity above the secured creditor's claims. The principal concern of the trustee and court was not the correctness of the appraisal, but whether, because of the unavailability of financing, a forced sale of the property at that time would realize the appraised value (Pet. App. 6a; A. 385a). This uncertainty could not be resolved unless there was a sale. While petitioner suggested that the property be abandoned to the second mortgagees (A. 390a), he did not file a motion to be allowed to reclaim the property, as required by the court in authorizing the arrangement plan (A. 196a), and he did not file a complaint to recover the property as required by Rule 701, Rules of Bankruptcy Procedure. Nor did petitioner appeal from the district court's order under which the property was ultimately sold.

Petitioner appears to contend (Br. 44 *et seq.*) that the trustee took the position that petitioner "should have filed an adversary proceeding to recover the property on which he held a mortgage." This misstates the government's argument. If the trustee had abandoned the property, petitioner would have been entitled to the rents arising after the abandonment. But the trustee believed that the property had value in excess of the security, and the court upheld his refusal to abandon the property. Thus, petitioner's extended discussion as to whether he took the necessary action to have the property abandoned to him under Rule 701 of the Bankruptcy Rules is beside the point. At all events, in authorizing petitioner's mortgage, the bankruptcy court ordered that petitioner could not reclaim the property without formally seeking permission to do so and setting forth his reasons (A. 196a). Petitioner never complied with this order.

jurisdiction of the bankruptcy court and, specifically, Section 57h of the Bankruptcy Act (11 U.S.C. 93 (h)). That provision states:

> The value of securities held by secured creditors shall be determined by converting the same into money according to the terms of the agree-

ment pursuant to which such securities were delivered to such creditors, or by such creditors and the trustee by agreement, arbitration, compromise or litigation, as the court may direct, and the amount of such value shall be credited upon such claims, and a dividend shall be paid only on the unpaid balance. Such determination shall be under the supervision and control of the court.

Section 57h and Rule 306(d), Rules of Bankruptcy Procedure,[21] require that the value of the security be deducted from the debt before a secured creditor may receive any benefit of a distribution out of the assets of the bankruptcy estate. *United States Bank* v. *Chase Bank, supra,* 331 U.S. at 34; 3 *Collier, supra,* § 57.20[1], at 330-333. Where property is sold free and clear of a lien, such as petitioner's second trust, the amount received from the sale may establish the value of the creditor's security for the purpose of applying Section 57h. *Hiscock* v. *Varick Bank of New York, supra; Sehon-Stevenson & Co.* v. *Union Trust Co.*, 113 F. 2d 968 (4th Cir. 1940); *In re Salmon Weed & Co.*, 53 F. 2d 335 (2d Cir. 1931). However, when the amount received from the sale is so grossly inadequate as to justify an inference of fraud or collusion, the proper value of the security may be litigated for the purpose of determining the

[21] Rule 306(d) provides "[i]f a secured creditor files a proof of claim, the value of the security interest held by him as collateral for his claim shall be determined by the court, and the claim shall be allowed only to the extent it is enforceable for any excess of the claim over such value."

secured creditor's entitlement under Section 57h. *Hiscock* v. *Varick Bank of New York, supra,* 206 U.S. at 38; 3 *Collier, supra,* § 57.20[5.21], at 348-351.[22]

When the bankruptcy court ordered a sale of the property in this case, the protections accorded petitioner were therefore parallel to his rights under North Carolina law. If bankruptcy had not intervened and the amount bid in by petitioner or any other purchaser at a foreclosure sale did not fully satisfy the amount due petitioner on his debt, he would have been entitled to pursue the debtor for a deficiency judgment for the balance of the debt. But this deficiency judgment would not be entitled to any priority over other general unsecured claims until docketed, but would merely share in the debtor's other property on a pro rata basis with those other claims.

Here, Section 57h of the Bankruptcy Act requires a similar result. Pursuant to that provision, the bankruptcy court determined the value of the security held by petitioner "by converting the same into money

[22] Even in the absence of fraud, where the amount received from a sale does not reflect the true value of the security and the secured creditor buys the property at the sale, the court, in the proper exercise of its equity powers, may ascertain the true value of the security. See *Richmond Mortgage & Loan Corp.* v. *Wachovia Bank, supra,* 300 U.S. at 131; *Honeyman* v. *Jacobs,* 306 U.S. 539, 543 (1939). Here, there is every indication that the property was worth more than the amount bid in by petitioner. The bankruptcy court, however, allowed the difference between the face value of petitioner's debt and the amount bid in for the property as a general unsecured claim (Pet. App. 13a).

according to the terms of the agreement," *i.e.*, it sold the property at a foreclosure sale. It thereafter credited "the amount of such value * * * upon [petitioner's claim]" and allowed the difference as an unsecured claim against the bankrupt estate. In short, Section 57h, like state law, contemplates a sale of the security as described in the instrument upon which the creditor bases his claim. Since the mortgage did not provide for a security interest in the accrued rents and petitioner took no steps to obtain the incidents of ownership (*i.e.*, the rents) prior to the foreclosure sale,[23] his security interest is necessarily limited to the value obtained at the sale.

3. Finally, the requirement that the mortgagee take affirmative action, consistent with state law, to secure an interest in the rents furthers a more orderly and certain administration of the bankruptcy estate. Such a requirement provides both the bankruptcy court and the parties with early notice of the nature and extent of the mortgagee's claim and enables the court to take that claim into account prior to any sale of the property.

In sum, the consistency of result between state and federal proceedings, the general policy of the

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[23] Compare *Fidelity Bankers Life Insurance Co.* v. *Williams*, *supra*, 506 F.2d at 1243. There, the court held that the mortgagee was entitled to the rents even though he had not taken possession of the property or sought the appointment of a receiver to sequester the rents for his benefit because the mortgagor had executed a supplemental agreement directly assigning all rents to the mortgagee upon default.

Bankruptcy Act that the validity of liens be determined under state law, and the orderly administration of the bankruptcy estate all favor the recognition of the majority view, *viz.*, that when bankruptcy creates a default on a mortgage, the mortgagee is entitled to the rents only when he takes those steps that would gain him a security interest in the rents under state law.

D. The Minority Line Of Decisions Rejecting The Application Of State Law Is Based Upon The Erroneous Premise That Bankruptcy Destroys The Mortgagee's Remedies Under State Law Without Providing An Equivalent Remedy In Bankruptcy

Petitioner rejects the application of the foregoing majority line of decisions holding that state law governs a mortgagee's right to rents accrued during bankruptcy. He relies (Br. 34-40) upon the minority view of the Third and Seventh Circuits that a mortgagee may recover the rents without regard to his right to them under state law if he can establish an "equitable" basis for his claim. *Bindseil* v. *Liberty Trust Co.*, *supra*; *In re Wakey*, *supra*; *In re Pittsburgh-Duquesne Development Co.*, *supra*, 482 F.2d at 246. See also 4A *Collier*, *supra*, § 70.16, at 167-168.

The seminal precedent in this minority line of decisions is *Bindseil* v. *Liberty Trust Co.*, *supra*. There, the court acknowledged that state law generally required the mortgagee to take possession of the property or sequester the rents before he could claim settlement to them (248 F. at 113). The court further observed that prior cases had applied the same rule in bankruptcy. See, *e.g.*, *In re Foster*, 9 F. Cas.

523 (E.D. N.Y. 1872), aff'd, 9 F. Cas. 572 (2d Cir. 1874); *In re Dole*, 110 F. 926 (D.Vt. 1901); *In re Banner*, 149 F. 936 (S.D. N.Y. 1907). The court held, however, that the rents should be awarded to the mortgagee when bankruptcy ensues even though state law did not establish a lien on the rents. The heart of the Third Circuit's reasoning (248 F. at 114) was that "bankruptcy changes the whole situation, takes from the mortgagor his land and its income, and takes from the mortgagee the legal remedies which, but for bankruptcy, he might pursue in reaching rents arising from the mortgaged premises, and gives him in lieu thereof, only such remedies as may be found in a court of bankruptcy in the equitable administration of the bankrupt's assets."

1. *Bindseil* and the decisions following it are based upon the erroneous premise that bankruptcy destroys the mortgagee's state law remedies without providing an equivalent remedy in bankruptcy. As we have pointed out *supra*, pages 38-42, while the bankruptcy court assumes exclusive jurisdiction over the property, vests possession in the trustee, and may enjoin any attempt by the mortgagee to initiate a state court proceeding to gain possession,[24] the mortgagee's remedies in the bankruptcy court are similar to those that would have been available to him in a state court.

For example, the mortgagee could gain possession of the property by consent or judicial action under state law. In bankruptcy, the trustee can abandon

[24] See *Ex parte Baldwin*, 291 U.S. 610, 615 (1934); Rule 601(a) of the Rules of Bankruptcy Procedure.

the property to the mortgagee (see 4A *Collier*, *supra*, § 70.42, at 499 *et seq.*), thereby accomplishing the same result. If the trustee refuses to abandon the property, the mortgagee can litigate the question by filing a complaint to claim the property. See 4A *Collier*, *supra*, § 70.39, at 466. Moreover, upon the commencement of a bankruptcy proceeding, the mortgagee can seek the appointment of a receiver to collect the rents for his benefit. Section 2a(3) of the Bankruptcy Act (11 U.S.C. 11(a)(3)); Rule 201, Rules of Bankruptcy Procedure. Indeed, even after adjudication and the appointment of a trustee, the mortgagee may apply to the court to have the trustee collect and sequester the rents for his benefit. See, *e.g.*, *In re Brose*, *supra*; *In re American Fuel & Power Co.*, *supra*. In cases where the value of the security is inadequate or questionable, the mortgagee is therefore accorded similar remedies in the bankruptcy court to gain an interest in the rents that would otherwise be available if bankruptcy had not occurred. Thus, contrary to the assumption of *Bindseil*, bankruptcy does not cut off the mortgagee's remedies so as to require an "equitable" adjustment of the rights of the parties.[25]

[25] Petitioner asserts (Br. 37) that the reasons for requiring a mortgagee to take possession of the property or to obtain a receiver to sequester the rents are to protect the mortgagee against the loss in value of his security due to the mortgagor's mismanagement. He contends (*ibid.*) that "[t]his idea has no application in a bankruptcy situation because the Court is in possession of the land." But the bankruptcy court does not assume jurisdiction over the bankrupt estate solely for the pro-

2. Moreover, by determining the mortgagee's rights to the rents without regard to state law, *Bindseil* in effect gives the mortgagee a priority status based solely upon "equitable" considerations over the claims of other secured creditors and the general unsecured creditors, including, as in this case, the claims for administration expense. In this respect, *Bindseil* conflicts with the well-settled proposition that Congress, and not equitable principles, establishes the order in which claims are to be paid in bankruptcy. See *Missouri* v. *Ross*, 299 U.S. 72, 74-75 (1936); *United States* v. *Randall*, 401 U.S. 513 (1971); *In re Columbia Ribbon Co.*, 117 F.2d 999, 1001 (3d Cir. 1941).

Bindseil also conflicts with the equality of distribution of the assets of the estate required by the Bankruptcy Act. See Section 65a of the Act (11 U.S.C. 105(a); *United States* v. *Randall*, *supra*. As we have pointed out (*supra*, pages 29-30), the decisions uniformly hold that state law controls the nature and extent of a secured creditor's claims to the assets of the bankrupt.[26] The effect of *Bindseil*, however, is

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tection of a single creditor but to insure the equitable distribution of the estate to all of the creditors in accordance with the priorities established by the Bankruptcy Act.

[26] Petitioner contends (Br. 32) that federal law should supersede state law in determining the extent of his security interest because the bankruptcy court's jurisdiction "has disrupted the mortgage relationship to such an extent that it preempts the field." Like the Third Circuit's rationale in *Bindseil*, this argument rests upon the mistaken notion that bankruptcy cuts off petitioner's remedies under state law without providing him with equivalent remedies in the bankruptcy proceeding.

to encumber additional assets for the benefit of one creditor regardless of his position under state law. As the Third Circuit explained, "[t]his view is not based upon the notion that the mortgage confers a lien on rents, for, of course, it does not; but it is based upon what is conceived to be an equitable adjustment of rights, of which some are obviously superior to others" (248 F. at 114).

But if the mortgagee's security does not extend to the rents under state law, it is difficult to justify the application of any principle that would shift assets from the payment of unsecured claims to secured claims on the basis of some "obvious" equitable superiority. Assuming that the mortgagee's security is inadequate and that there are insufficient funds to satisfy both secured and unsecured claims, the Bankruptcy Act allows the balance of the secured creditor's

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At all events, the decisions uniformly hold that state law determines the extent of the bankrupt's interest and whether that interest passes to the trustee. See, *e.g.* (in addition to the cases cited *supra*, page 30), *Pearlman* v. *Reliance Ins. Co.*, 371 U.S. 132, 136 (1962); *Hayes* v. *Schaefer*, 399 F.2d 300, 301 (6th Cir. 1968); *In re Wetteroff*, 453 F.2d 544, 546 (8th Cir. 1972); *Wiley* v. *Public Investors Life Insurance Co.*, 498 F.2d 101, 103 (5th Cir. 1974); *In re McClain*, 447 F.2d 241, 243-244 (10th Cir. 1971); *State of Ohio* v. *Four Seasons Nursing Centers of America, Inc.*, 465 F.2d 25, 27-28 (10th Cir. 1972). Creditors' rights and powers in bankruptcy are likewise determined under state law. *E.g.*, *Bass* v. *Aetna Factors Co.*, 272 F.2d 707 (9th Cir. 1959); *Martin* v. *Crocker-Citizens National Bank*, 349 F.2d 580 (9th Cir. 1965); *Willard* v. *Petruska*, 356 F.2d 422 (5th Cir. 1966); *In re Luther*, 465 F.2d 19, 20 (9th Cir. 1972).

claim above the value of his security as an unsecured claim to be shared ratably with the general unsecured creditors. See Sections 57h and 65 of the Act (11 U.S.C. 93(h) and 105). The proper application of equity jurisdiction is to reject advantages to some creditors at the expense of other creditors. See *Pepper* v. *Litton*, 308 U.S. 295 (1939), and discussion, *supra*, pages 26-28.

Simply put, the result of *Bindseil* is to place the mortgagee in a better position when bankruptcy ensues than he would have had in a nonbankruptcy setting. See Comment, *The Mortgagee's Rights to Rents and Profits Following a Petition in Bankruptcy*, 60 Iowa L. Rev. 1388, 1400 (1975). See also 4A *Collier*, *supra*, § 70.16, at 167-168. Indeed, if the Third Circuit's rationale is carried to its logical conclusion, in any case where the security is insufficient, a mortgagee would be allowed to prevail over the general creditors even though he would not be entitled to obtain even a deficiency judgment under state law. See, *e.g.*, N.C. Gen. Stat. § 45-21.38 (1976 Repl.). Such a windfall should not be permitted in a bankruptcy proceeding. To the contrary, the rights of secured creditors should be determined strictly in accordance with the security agreement, and the effect of that agreement under state law.

3. Finally, we submit that the equitable approach of *Bindseil* would foster uncertainty as to the financial condition of the bankrupt estate and disrupt its subsequent distribution. Under the equitable view, the mortgagee is not required to take any action that

would provide notice of his claim to interested parties. But the mortgagee is generally in a better position than the other creditors to evaluate the adequacy of his security. It surely would be better practice to require the mortgagee to notify the court that the value of his security is questionable at an early stage of the proceeding so that the court may consider the possibility that he may claim the rents. Like any other creditor, a mortgagee should advance his claim in such a manner as to put the court, the trustee and the other creditors on timely notice, rather than waiting until the estate has been liquidated and largely distributed.

Indeed, the facts of this case illustrate this point with particular force. Here, when the bankruptcy court ordered the trustee not to make payments to the mortgagees, it expressed a concern (A. 799a) that the funds could be needed to pay expenses of administration, which, in fact, turned out to be the case. Nothing in the record indicates that petitioner objected to this order. In fact, when he filed his proof of claim, he asserted a security interest only in the property and not in the rents (A. 443a). However, if petitioner had taken affirmative action in the bankruptcy court to seek to have the rents collected for his benefit in the event the security was inadequate, the trustee and other creditors would have been informed of the extent of his claim and may well have avoided the uncertainties in the distribution of the estate occasioned by petitioner's eleventh-hour claim for the rents.

E. The Court Of Appeals Correctly Held That Petitioner Did Not Take Sufficient Action In The Bankruptcy Proceeding To Qualify For A Security Interest In The Rents Under North Carolina Law

Even on the assumption that the court of appeals correctly concluded that the question of the mortgagee's entitlement to rents was determined by reference to state law, petitioner argues (Br. 41-50) that he took sufficient action during the bankruptcy proceeding to gain a security interest in the rents under the law of North Carolina. The sole basis for petitioner's contention is that the debtor moved in the arrangement proceeding to have an agent appointed to collect the rents and to apply "the funds to those debts approved for payment by this Court" (A. 203a). The court appointed an agent to collect the rents and to apply them to income taxes, first mortgage payments, property taxes, insurance premiums and second mortgage payments (A. 205a-206a). In petitioner's view, this order, designating an agent for the debtor to collect the rents, established a receivership for the purposes of securing the mortgagee's rights to the rents.

To begin with, the disputed rents in this case are not those collected by the agent during the arrangement proceeding but those collected by the trustee after adjudication of bankruptcy. More important, however, the record squarely refutes petitioner's contention that a receivership was ever established to collect the rents for his benefit. At the time the agent was appointed during the Chapter XI proceedings, Golden's real estate operations were its only income-

producing activity. The agent was appointed "to collect rents and to apply the proceeds under the supervision of the Court" (A. 204a). But Golden was still in possession of the property, and there was no suggestion that the agent was intended to divest the rights of Golden or its other creditors to the rents in favor of the second mortgagee. Indeed, Golden's motion to appoint an agent requested that the excess rents, after first mortgage, tax, and insurance payments, be accumulated for the benefit of the second mortgagees *and* "the unsecured creditors" (A. 203a).[27] Thus, the appointment of an agent was nothing more than an administrative order to facilitate collection of the rents; it altered no existing rights of Golden or its creditors to the rents.[28] Moreover, since

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[27] Although the bankruptcy court subsequently issued a Disbursement Order (A. 229a-235a) permitting disbursements to the first and second mortgage holders, petitioner was willing to forego receiving these payments (A. 275a). Furthermore, it does not appear that this order was ever implemented during the arrangement proceeding, and it was never implemented during the liquidation proceeding (see page 52, *infra*). Thus, petitioner properly refrains from relying on this order.

[28] The court of appeals (Pet. App. 36a) mistakenly referred to the agent as a receiver. Relying on this characterization, petitioner contends (Br. 50-55) that the court erroneously held that the Chapter XI proceedings were not a part of bankruptcy. But whether or not the agent is properly characterized as a receiver, the significant fact is that he was not appointed solely to protect petitioner's interest but to protect the interests of all creditors. There is accordingly no basis for petitioner's contention that a receiver was appointed to collect the rents for his benefit.

Golden did not default on payments to petitioner until October 31, 1974 (A. 266a-268a), there would have been no reason for the court to have appointed a receiver solely for petitioner's benefit.

This construction is not only supported by the terms of the order but also by petitioner's actions subsequent to its issuance. After Golden was adjudicated a bankrupt, the trustee was appointed. His authority superseded that of the agent, and he was specifically instructed to collect the rents "and to hold and retain all moneys thus received to the end that the same may be applied under this or different or further orders of this Court" (A. 343a). While the bankruptcy court's order gave the trustee the authority to make certain payments, it did not authorize him to make payments on the mortgages (A. 341a-342a). Neither petitioner nor the other second mortgagees objected to this order.

Petitioner submits, however, that the court's reference to "different" orders refers to the order appointing the agent. He therefore concludes that the trustee collected the rents for his benefit (see Br. 51). But this contention misconceives the effect of the appointments of the agent and trustee; neither order purported to instruct the agent or the trustee to sequester the rents for petitioner's benefit.[29] Moreover, on July

[29] Even assuming that petitioner might not have apprehended the proper significance to be given to the court's order, the trustee, shortly after his appointment, notified petitioner that the bankruptcy court had ordered the trustee not to make any payments on the mortgages (A. 799a). Thus, any possible reliance petitioner may have placed upon the order appointing the agent would have been dispelled at that time. Thereafter, the rents accrued monthly, and the trustee filed monthly reports showing receipts and disbursements; neither petitioner nor the first mortgagees, however, interposed any objection.

1, 1975, petitioner filed his claim as a secured creditor and he stated that he did not "hold * * * any security for the debt * * * for the claimant's use except * * *" the note and deed of trust (A. 443a). When this claim was filed, the trustee had collected more than $82,000 in rents (A. 436a). Petitioner thus expressly limited his claim for a security interest to the value of the property without regard to the rents.[30]

Indeed, after the property was sold, petitioner accepted a deed from the trustee which specifically did not convey to him rights to the collected and accrued rents, but reserved them to the trustee (A. 672a-673a). Petitioner did not object to this provision in the deed.

In short, neither the court, the other creditors, nor petitioner himself ever regarded the order appointing the agent to collect the rents during the arrangement proceeding as providing for the sequestration of rents solely for petitioner's benefit. And petitioner neither sought nor obtained an order in the liquidation proceeding to have the trustee collect the rents for his

[30] Prior to this time, the United States had filed proofs of claims for taxes (A. 95a, 197a), and, shortly thereafter, attorneys for the creditors' committee filed applications for fees (A. 475a, 572a). Even though petitioner was aware that the assets of the estate were limited, and that there were substantial adverse claims to the fund, he took no steps to insure that the rents were being collected for his benefit.

benefit. The record therefore convincingly demonstrates the correctness of the court of appeals' conclusion that petitioner did not take sufficient steps during the bankruptcy proceeding to qualify for a security interest in the rents under North Carolina law.[31]

Finally, petitioner argues (Br. 38) that his claim should not be defeated by a "technical rule" requiring specific sequestration of the rents. But as we have pointed out *supra*, the rule petitioner condemns as "technical" is in accord with the general policy of the Bankruptcy Act to determine the validity of liens under state law and fosters uniformity of result between federal and state proceedings. Moreover, as a practicing lawyer in North Carolina, petitioner can hardly claim ignorance of the law of that jurisdiction, especially when the rule in question has been extant for almost a century. Thus, the requirement that the mortgagee establish possession of the property or sequester the rents for his benefit is neither technical nor esoteric.

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[31] While the district court expressed the view (Pet. App. 27a) that the trustee "continued to collect these rents and profits, and to hold them in accordance with the original order," it, like petitioner, misapprehended the effect of the original order. Contrary to the district court's assumption, that order issued during the arrangement proceeding did not require the collection of rents solely for petitioner's benefit but provided for their collection for the benefit of all of Golden's creditors (A. 203a). Thus, as the court of appeals correctly observed (Pet. App. 36a), "manifestly, what the district court thought was being done was not being done."

Nor can petitioner fairly accuse (Br. 37 *et seq.*) the bankruptcy court of delay that reduced the proceeds of the foreclosure sale. As we have pointed out (*supra*, pages 38-39, note 20), the bankruptcy court postponed the sale of the property until financing became more generally available. Surely, it was within the sound discretion of the bankruptcy court to take the availability of local mortgage money into account in fixing the date of sale.

Indeed, the facts of this case establish that any delay is properly attributed to petitioner in advancing his claim to a security interest in the rents. Here, the mortgage was placed upon the property by the bankruptcy court during an attempted resuscitation of the debtor in the Chapter XI arrangement.[32] It contained no provision with respect to rents in the event of default. Moreover, the arrangement plan to which petitioner and the other holders of the trust agreed (A. 162a) did not provide for any security interest in the rents. In fact, petitioner did not claim the rents even when the trustee notified him that the secured creditors would not be paid but delayed making his claim until after the property had been conveyed to him. Finally, petitioner agreed that he would not foreclose or reclaim the property without approval of the court upon a showing of justification (A. 196a). In these circumstances, petitioner can

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[32] In part, the trust under which petitioner claims the rents replaced a prior trust held by petitioner and McKaughn. The later trust, however, was not an extention of the earlier one. Both the amount of the indebtedness and the creditors secured by the trust were altered (see A. 156a-157a).

hardly complain that the bankruptcy court's delay in selling the property undermined his position when he had ample opportunity to request that his security interest extend to the rents but failed to do so.

F. Petitioner Would Not Be Entitled To The Rents Even Under The Minority View Rejecting The Application Of State Law In Favor Of Equitable Principles

As we have argued in the foregoing portions of this brief (*supra*, pages 36-43), the majority line of decisions holding that state law governs a mortgagee's right to rents are in accord with the established policy of the Bankruptcy Act that state law determines the validity of the interests of secured creditors. But even if the Court were to reject our submission in favor of the equitable approach of the minority view, petitioner would not be entitled to the rents.

The equitable approach of the *Bindseil* line of decisions is based upon the notion that the mortgagee has a better equitable claim to the rents, as security for his debt, than the unsecured creditors. Since the purpose of a mortgage is to secure an obligation of the debtor, if the mortgagee takes possession of the property, he is accountable and must turn over to the mortgagor any excess of rents or profits received prior to the sale above the amount required to make him whole. When bankruptcy occurs, the trustee succeeds to the rights of the bankrupt and would be entitled to the same rights for an accounting and to any excess. Accordingly, under the equitable rule of the Third and Seventh Circuits, if the mortgagee has been made whole on his debt, he cannot claim the

rents as a matter of equity. See *Honeyman* v. *Jacobs*, 306 U.S. 539 (1939); *Richmond Corp.* v. *Wachovia Bank*, *supra*. The mortgagee therefore is not entitled to the rents unless he establishes that "the mortgaged property was worth less than the mortgaged indebtedness." *In re Cigar Stores Realty Holdings*, *supra*, 69 F.2d at 824. See also 4A *Collier*, *supra*, § 70.16, at 168 n.46.

Here, petitioner has not established the existence of any deficiency between his debt and the value of the property. Indeed, the record establishes that the value of the property he received was greater than the amount of his security.

Petitioner's claim to the rents is based on an alleged loss measured by the difference between the face amount of the mortgage ($360,000) and the bid-in price of $174,000. He relies entirely on these figures as proof that he has not been made whole. However, shortly after the sale of the property to him, petitioner refinanced Tracts I, II and III. After this refinancing, the new trusts on the properties totalled $587,000,[33] and, after paying the prior first trusts and expenses of refinancing, petitioner received a net amount in cash of $130,981.23.[34] Thus, as the trustee's uncontradicted affidavit states (A. 780a), assuming that the lending institutions required no margin of security, the value of petitioner's security

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[33] Trade I—$85,000 (A. 779a); Tract II—$212,000 (A. 778a); Tract III—$290,000 (A. 778a).

[34] Tract I—$36,479.49 (A. 779a); Tract II—$28,034.24 (A. 778a); Tract III—$66,467.50 (A. 778a).

in these three tracts was at least $130,981, measured by the excess cash he received over the prior first trusts.

Moreover, the record shows that petitioner sold a portion of Tract IV and received, after paying the first mortgage and expenses, $162,049 in cash (A. 777a). The appraised value of the retained portion of Tract IV was $50,000 (A. 779a). Thus, the conservative value of petitioner's security in the four tracts was at least $343,030.[35] Finally, the record shows that petitioner's investment in the mortgage was not the face amount of $360,000, but was only $272,000 (A. 780a), leaving an excess of the value of the security over his investment of approximately $71,030 ($343,030 − $272,000).

Petitioner did not challenge the correctness of this analysis in the district court; indeed, he concedes (Pet. 22) that he profited on the sale of Tract IV by "no more than $165,225.45." He nevertheless argues (Br. 50) that these facts were "based purely on information contained in the public records * * * and in no way represent[ed] the costs incurred by [him]." But nowhere in the record are there any facts, or indeed a proffer of facts, suggesting why

[35] Assuming that a reasonable margin of security was required, the value of petitioner's security would approximate the excess cash he received over the amounts of the first trusts plus the appraised value of the retained land, as follows:

Indicated value of security in Tracts I-III	$130,981
Indicated value of security in Tract IV (sold)	162,049
Indicated value of security in Tract IV (retained)	50,000
	$343,030

these public records are unreliable or that the trustee's uncontradicted affidavit is inaccurate. Thus, from the record, it would appear that petitioner realized on his security approximately $70,000 more than his investment in the mortgage. In these circumstances, the court of appeals correctly concluded (Pet. App. 38a) that even "[i]f equity has a part in the resolution of a question of this type * * * equity does not supply the answer here."

Contrary to petitioner's suggestion (Br. 49-50), we do not contend that it was improper for him to realize a profit on his investment. Our purpose in calling these portions of the record to the attention of the Court is to show that it would be a highly improper exercise of the bankruptcy court's equity powers to allow petitioner a further profit by shifting the rents to him at the expense of the claims of other creditors. While the balance of petitioner's claim may be allowable as an unsecured claim under Section 57h, a result which one commentator characterizes as "deplorable" in its unfairness to the other creditors and calling for legislative action (3 *Collier*, *supra*, § 57.07[2], p. 166), it is quite a different matter to provide petitioner with an additional windfall in the form of a security interest in the rents to the detriment of the other creditors.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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APPENDIX

Bankruptcy Act, 30 Stat. 544, as amended (11 U.S.C. 1 *et seq.*):

Section 57. *Proof and allowance of claims.*

a. A proof of claim shall consist of a statement, in writing and signed by a creditor, setting forth the claim; the consideration therefor; whether any and, if so, what securities are held therefor; and whether any and, if so, what payments have been made thereon; and that the claim is justly owing from the bankrupt to the creditor. A proof of claim filed in accordance with the requirements of this title, the General Orders of the Supreme Court, and the official forms, even though not verified under oath, shall constitute prima facie evidence of the validity and amount of the claim.

* * * * *

h. The value of securities held by secured creditors shall be determined by converting the same into money according to the terms of the agreement pursuant to which such securities were delivered to such creditors, or by such creditors and the trustee by agreement, arbitration, compromise or litigation, as the court may direct, and the amount of such value shall be credited upon such claims, and a dividend shall be paid only on the unpaid balance. Such determination shall be under the supervision and control of the court.

* * * * *

[11 U.S.C. 93.]

Section 60. *Preferred creditors.*

a. (1) A preference is a transfer, as defined in this title, of any of the property of a debtor to or for the benefit of a creditor for or on account of an antecedent debt, made or suffered by such debtor while insolvent and within four months before the filing by or against him of the petition initiating a proceeding under this title, the effect of which transfer will be to enable such creditor to obtain a greater percentage of his debt than some other creditor of the same class.

* * * * *

b. Any such preference may be avoided by the trustee if the creditor receiving it or to be benefited thereby or his agent acting with reference thereto has, at the time when the transfer is made, reasonable cause to believe that the debtor is insolvent. Where the preference is voidable, the trustee may recover the property or, if it has been converted, its value from any person who has received or converted such property, except a bona-fide purchaser from or lienor of the debtor's transferee for a present fair equivalent value: *Provided, however*, That where such purchaser or lienor has given less than such value, he shall nevertheless have a lien upon such property, but only to the extent of the consideration actually given by him. Where a preference by way of lien or security title is voidable, the court may on due notice order such lien or title to be preserved for the benefit of the estate, in which event such lien or title shall pass to the trustee. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which

would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

* * * * *

[11 U.S.C. 96.]

Section 67. *Liens and fraudulent transfers.*

a. (1) Every lien against the property of a person obtained by attachment, judgment, levy, or other legal or equitable process or proceedings within four months before the filing of a petition initiating a proceeding under this title by or against such person shall be deemed null and void (a) if at the time when such lien was obtained such person was insolvent or (b) if such lien was sought and permitted in fraud of the provisions of this title: *Provided, however*, That if such person is not finally adjudged a bankrupt in any proceeding under this title and if no arrangement or plan is proposed and confirmed, such lien shall be deemed reinstated with the same effect as if it had not been nullified and voided.

* * * * *

d. (1) For the purposes of, and exclusively applicable to, this subdivision: (a) "Property" of a debtor shall include only his nonexempt property; (b) "debt" is any legal liability, whether matured or unmatured, liquidated or unliquidated, absolute, fixed, or contingent; (c) "creditor" is a person in whose favor a debt exists; (d) a person is "insolvent" when the present fair salable value of his property is less than the amount required to pay his debts; and to determine whether a partnership is insolvent,

there shall be added to the partnership property the present fair salable value of the separate property of each general partner in excess of the amount required to pay his separate debts, and also the amount realizable on any unpaid subscription to the partnership of each limited partner; and (e) consideration given for the property or obligation of a debtor is "fair" (1) when, in good faith, in exchange and as a fair equivalent therefor, property is transferred or an antecedent debt is satisfied, or (2) when such property or obligation is received in good faith to secure a present advance or antecedent debt in an amount not disproportionately small as compared with the value of the property or obligation obtained.

(2) Every transfer made and every obligation incurred by a debtor within one year prior to the filing of a petition initiating a proceeding under this title by or against him is fraudulent (a) as to creditors existing at the time of such transfer or obligation, if made or incurred without fair consideration by a debtor who is or will be thereby rendered insolvent, without regard to his actual intent; or (b) as to then existing creditors and as to other persons who become creditors during the continuance of a business or transaction, if made or incurred without fair consideration by a debtor who is engaged or is about to engage in such business or transaction, for which the property remaining in his hands is an unreasonably small capital, without regard to his actual intent; or (c) as to then existing and future creditors, if made or incurred with-

out fair consideration by a debtor who intends to incur or believes that he will incur debts beyond his ability to pay as they mature; or (d) as to then existing and future creditors, if made or incurred with actual intent as distinguished from intent presumed in law, to hinder, delay, or defraud either existing or future creditors.

(3) Every transfer made and every obligation incurred by a debtor who is or will thereby be rendered insolvent, within four months prior to the filing of a petition initiating a proceeding under this title by or against him is fraudulent, as to then existing and future creditors: (a) if made or incurred in contemplation of the filing of a petition initiating a proceeding under this title by or against the debtor or in contemplation of liquidation of all or the greater portion of the debtor's property, with intent to use the consideration obtained for such transfer or obligation to enable any creditor of such debtor to obtain a greater percentage of his debt than some other creditor of the same class, and (b) if the transferee or obligee of such transfer or obligation, at the time of such transfer or obligation, knew or believed that the debtor intended to make such use of such consideration. The remedies of the trustee for the avoidance of such transfer or obligation and of any ensuing preference shall be cumulative: *Provided, however,* That the trustee shall be entitled to only one satisfaction with respect thereto.

(4) Every transfer of partnership property and every partnership obligation incurred within one year prior to the filing of a petition initiating a proceeding under this title by or against

the partnership, when the partnership is insolvent or will be thereby rendered insolvent, is fraudulent as to partnership creditors existing at the time of such transfer or obligation, without regard to actual intent if made or incurred (a) to a partner, whether with or without a promise by him to pay partnership debts, or (b) to a person not a partner without fair consideration to the partnership as distinguished from consideration to the individual partners.

(5) For the purposes of this subdivision, a transfer shall be deemed to have been made at the time when it became so far perfected that no bona fide purchaser from the debtor could thereafter have acquired any rights in the property so transferred superior to the rights of the transferee therein, but, if such transfer is not so perfected prior to the filing of the petition initiating a proceeding under this title, it shall be deemed to have been made immediately before the filing of such petition.

(6) A transfer made or an obligation incurred by a debtor adjudged a bankrupt under this title, which is fraudulent under this subdivision against creditors of such debtor having claims provable under this title, shall be null and void against the trustee, except as to a bona fide purchaser, lienor, or obligee for a present fair equivalent value: *Provided, however*, That the court may, on due notice, order such transfer or obligation to be preserved for the benefit of the estate and, in such event, the trustee shall succeed to and may enforce the rights of such transferee or obligee: *And provided further*, That such purchaser, lienor, or obligee, who

without actual fraudulent intent has given a consideration less than fair, as defined in this subdivision, for such transfer, lien, or obligation, may retain the property, lien, or obligation as security for repayment.

(7) Nothing contained in this subdivision shall be construed to validate a transfer which is voidable under section 96 of this title.

e. For the purpose of any recovery or avoidance under this section, where plenary proceedings are necessary, any State court which would have had jurisdiction if bankruptcy had not intervened and any court of bankruptcy shall have concurrent jurisdiction.

f. (1) For the purposes of, and exclusively applicable to, this subdivision (a) "debtor" shall mean a face-amount certificate company as defined in section 80a-4 of title 15; "face-amount certificate" shall mean a face-amount certificate as defined in section 80a-2 of title 15; (c) "depositary" is a person or State agency with whom securities or other property of a debtor is deposited or to whom property of a debtor is transferred, in trust or otherwise, pursuant to the requirements of a State law or an agreement by the debtor providing for the distribution of such property or its proceeds to creditors or security holders of the debtor in the event of the insolvency of the debtor or under other specified circumstances; (d) "deposit creditor" is a creditor who, under the provisions of a State law or agreement providing for a deposit with or transfer to a depositary, has rights as to the securities or property so deposited or transferred which exceed the rights of a general creditor;

and (e) "State agency" is an official or agency of a State designated to act as depositary or to distribute property or the proceeds of property held by a depositary.

(2) Every deposit or transfer of securities or other property made by or on behalf of a debtor with or to any depositary for the benefit or protection of or to secure the holder of any security sold by or on behalf of the debtor on or after January 1, 1941, shall be voidable as against the trustee of such debtor if the property of the estate is insufficient for the full payment and discharge of all claims on account of all face-amount certificates sold by or on behalf of the debtor, and such deposit or transfer and every lien created thereby shall thereupon be avoided by the trustee subject to the provisions of paragraph (3) of this subdivision.

(3) In the event any deposit or transfer described in paragraph (2) of this subdivision shall be avoided the trustee shall segregate the property received by the trustee from the depositary and charge the same with the costs and expenses of maintenance and liquidation and distribute the net proceeds thereof to the creditors who would have been entitled thereto under the provisions of the law or agreement providing for the deposit or transfer of the property and each such creditor shall thereafter be entitled to dividends from the estate only after all creditors of the same rank shall have received the same percentage.

(4) The court shall have summary jurisdiction of any proceedings to hear and determine the rights of any parties under this subdivision and

to hear and determine the sufficiency of the property of the estate for the full payment and discharge of all claims on account of all face-amount certificates sold by or on behalf of the debtor. Due notice of any hearing in such proceedings shall be given to every depositary and State agency which is a party in interest.

(5) Where the provisions of subsection (c) of section 28 are not applicable, the provisions of this section will not apply.

[11 U.S.C. 107.]

Section 70. *Title to property.*

a. The trustee of the estate of a bankrupt and his successor or successors, if any, upon his or their appointment and qualification, shall in turn be vested by operation of law with the title of the bankrupt as of the date of the filing of the petition initiating a proceeding under this title, except insofar as it is to property which is held to be exempt, to all of the following kinds of property wherever located (1) documents relating to his property; (2) interests in patents, patent rights, copyrights, and trademarks, and in applications therefor: *Provided,* That in case the trustee, within thirty days after appointment and qualification, does not notify the applicant for a patent, copyright, or trade-mark of his election to prosecute the application to allowance or rejection, the bankrupt may apply to the court for an order revesting him with the title thereto, which petition shall be granted unless for cause shown by the trustee the court grants further time to the trustee for making such election; and such applicant may, in any event, at any time petition the court to be revested with such title

in case the trustee shall fail to prosecute such application with reasonable diligence; and the court, upon revesting the bankrupt with such title, shall direct the trustee to execute proper instruments of transfer to make the same effective in law and upon the records; (3) powers which he might have exercised for his own benefit, but not those which he might have exercised solely for some other person; (4) property transferred by him in fraud of his creditors; (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered: *Provided*, That rights of action ex delicto for libel, slander, injuries to the person of the bankrupt or of a relative, whether or not resulting in death, seduction, and criminal conversation shall not vest in the trustee unless by the law of the State such rights of action are subject to attachment, execution, garnishment, sequestration, or other judicial process: *And provided further*, That when any bankrupt, who is a natural person, shall have any insurance policy which has a cash surrender value payable to himself, his estate, or personal representatives, he may, within thirty days after the cash surrender value has been ascertained and stated to the trustee by the company issuing the same, pay or secure to the trustee the sum so ascertained and stated, and continue to hold, own, and carry such policy free from the claims of the creditors participating in the distribution of his estate under the bankruptcy proceedings, otherwise the

policy shall pass to the trustee as assets; (6) rights of action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property; (7) contingent remainders, executory devises and limitations, rights of entry for condition broken, rights or possibilities of reverter, and like interests in real property, which were nonassignable prior to bankruptcy and which, within six months thereafter, become assignable interests or estates or give rise to powers in the bankrupt to acquire assignable interests or estates; and (8) property held by an assignee for the benefit of creditors appointed under an assignment which constituted an act of bankruptcy, which property shall, for the purposes of this title, be deemed to be held by the assignee as the agent of the bankrupt and shall be subject to the summary jurisdiction of the court.

All property, wherever located, except insofar as it is property which is held to be exempt, which vests in the bankrupt within six months after bankruptcy by bequest, devise or inheritance shall vest in the trustee and his successor or successors, if any, upon his or their appointment and qualification, as of the date when it vested in the bankrupt, and shall be free and discharged from any transfer made or suffered by the bankrupt after bankruptcy.

All property, wherever located, except insofar as it is property which is held to be exempt, in which the bankrupt has at the date of bankruptcy an estate or interest by the entirety and which within six months after bankruptcy becomes transferable in whole or in part solely by

the bankrupt shall, to the extent it becomes so transferable, vest in the trustee and his successor or successors, if any, upon his or their appointment and qualification, as of the date of bankruptcy.

The title of the trustee shall not be affected by the prior possession of a receiver or other officer of any court.

* * * * *

c. The trustee may have the benefit of all defenses available to the bankrupt as against third persons, including statutes of limitations, statutes of frauds, usury, and other personal defenses; and a waiver of any such defense by the bankrupt after bankruptcy shall not bind the trustee. The trustee shall have as of the date of bankruptcy the rights and powers of: (1) a creditor who obtained a judgment against the bankrupt upon the date of bankruptcy, whether or not such a creditor exists, (2) a creditor who upon the date of bankruptcy obtained an execution returned unsatisfied against the bankrupt, whether or not such a creditor exists, and (3) a creditor who upon the date of bankruptcy obtained a lien by legal or equitable proceedings upon all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt upon a simple contract could have obtained such a lien, whether or not such a creditor exists. If a transfer is valid in part against creditors whose rights and powers are conferred upon the trustee under this subdivision, it shall be valid to a like extent against the trustee. In cases where repugnancy or inconsistency exists with reference to the

rights and powers in this subdivision conferred, the trustee may elect which rights and powers to exercise with reference to a particular party, a particular remedy, or a particular transaction, without prejudice to his right to maintain a different position with reference to a different party, a different remedy, or a different transaction.

* * * * *

[11 U.S.C. 110.]

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